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Foreword

OUR SOUTHWESTERN OFFICES

The firm has long been represented in the growing and economically important Southwest area of the country; first by representation of Messrs. Peter & Moss beginning in 1914, and since 1930 when their practice was merged with ours, thus establishing our own Dallas office. The Houston office was opened in 1931, and both have assisted our clients in meeting the complex accounting and tax problems resulting from the phenominal growth of ranching, agriculture, mining, oil and chemical industries in that section of the United States and in Mexico. More recently, in fact a year ago, it was determined to open an office in Tulsa, Oklahoma, to serve more effectively our clients centering about this fast-growing city. The needs of our Southwestern practice in the field of federal taxation has led us to assign to our Dallas office Mr. Godfrey W. Welsch, who has been associated with the tax staff of the New York office for a number of years. Mr. Welsch is exceptionally well experienced in tax problems of the oil and gas industry and we are sure that our clients in this and other fields will be well served by Mr. Welsch, who will officially start his work in Dallas about the end of June.

The Tax Aspects of the Ownership and Disposal of Interests in Oil and Gas

By G. W. Welsch
(Dallas Office)

Standard Oil and Gas Lease:

The simplest and most common form of ownership of an interest in oil and gas in place is that arising under a standard oil and gas lease. Usually negotiated with respect to unproven property, the oil and gas lease normally grants to an operator seven-eighths of the oil and gas in place, known as the "working interest." The lessor, owner of the mineral interests, and usually the surface rights as well, retains the right to one-eighth of the oil and gas free and clear of all production costs, when, as and if oil is produced. This retained right is known as the royalty interest. Written for a specified period of time, the oil and gas lease almost always contains a clause continuing it in effect for as long after said specified period of time that oil and gas is produced.

Delay rental—If the property subject to the oil and gas lease is in a "hot" area where leases are much in demand, the lease might contain a clause providing that unless a well is commenced within 60 days, the lease shall become null and void, but under ordinary circumstances, in lieu of such condition, there is a requirement that the lessee pay an annual "delay rental" of a nominal amount per acre for the privilege of deferring development of the property. Such delay rental, when received by the lessor, is ordinary income to him and is not subject to the allowance for depletion.[1] The lessee may deduct the amounts paid as delay rental[2] or may capitalize them as additional costs of the minerals, to be recovered through depletion or taken as a loss on abandonment of the property. An interest acquired under an oil and gas lease being considered "real property" for purposes of Federal income taxation, the privilege of capitalizing the delay rentals is part of the general election given to a taxpayer by the Internal Revenue Code to capitalize carrying charges on undeveloped property.[3]

Lease bonus—Usually, in addition to his retention of the royalty interest and his right to receive delay rentals, the landowner requires a "bonus payment" for granting an

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[1] Reg. 111, Sec. 29.23(m)-10(a); Comm. v. Wilson, 76 F. (2d) 766 (C. A. 5th 1935).

[2] G. C. M. 11197, C. B. XII-1, 238 (1933).

[3] I. R. C., Sec. 24(a) (7); Reg. 111, Sec. 29.24-5.

oil and gas lease. These "bonus payments" vary in amount from nominal sums per acre to very substantial payments depending upon the demand for leases in the area in which the property is located. Under the Internal Revenue Code, the "lease bonus" is treated as advance royalty to the recipient but as cost of the property to the payor.[4] The landowner must report the amount received as ordinary income but he is entitled to a deduction for statutory percentage depletion.[5] Percentage depletion on oil and gas is allowed in the amount of 27½% of the gross income from the property not to exceed 50% of the net income from the property.[6] Inasmuch as there are no charges against the "lease bonus" it is considered to be both gross income and net income from the property and therefore the landowner may take the full deduction of 27½% of the amount received. Of course, if there were a way of figuring cost depletion, and such cost depletion exceeded percentage depletion, the lessor would be entitled to take cost depletion. But the "lease bonus—advance royalty" is not paid with respect to any specified amount of oil to be removed from the property, and with undeveloped property it is impossible to estimate the amount of reserves in the property, so that even if the landowner could allocate a portion of his cost of the land to his retained royalty interest, the aliquot part thereof to be deducted as cost depletion could not be determined. In the event that the lease is abandoned by the lessee by nonpayment of rentals or expires under its own terms without production, the lessor must report as income in the year of such termination the amount he previously deducted as a depletion allowance.[7] This is true whether or not such deduction resulted in any tax benefit. It would appear, however, that if the taxpayer neglected to take the deduction in the year the bonus was received, he would not have to make any addition to income in the year that the lease was terminated without production.[8]

General Considerations on Disposition or Retention of "Working Interest":

Having acquired the "working interest" in the property, the lessee may develop it, sell it, sublease it, exchange all or a portion of it for all or a portion of other property or simply hold it on speculation, paying delay rentals while the play in an area develops and then, if indications from nearby development indicate little or no chance for oil or gas, abandon the lease by releasing it to the landowner either at expiration or prior thereto.

[4] Reg. 111, Sec. 29.23(m)-10(a); Murphy Oil Co. v. Burnet, 287 U. S. 299 (1932).

[5] Reg. 111, Sec. 29.23(m)-10(a).

[6] Reg. 111, Sec. 29.23(m)-4.

[7] Douglas v. Comm., 322 U.S. 275 (1944).

[8] Douglas v. Comm., 322 U. S. 275 (1944).

Each step to be taken with respect to an interest in oil and gas property should be reviewed carefully, in advance, with respect to possible Federal tax consequences. While it is never desirable to make business decisions solely upon the basis of the tax advantages to be gained from a course of action, when there are two or more methods of handling a transaction which will produce almost identical results, it is encumbent upon any businessman in this era of high taxes, to choose the means to the desired end which will result in the smallest tax burden. For example, assume that the lessee, having held the working interest while the play developed favorably in the area, now has a chance to dispose of all or a portion of his working interest at a substantial profit. If he wishes to dispose of his entire interest, he has no problem. Having held the property over 6 months, the gain he realizes on the sale will be treated as long-term gain from the sale of a capital asset[9] unless he is in the business of dealing in oil and gas leases.[10] On the other hand, should the lessee desire to retain a continuing interest in the property, there are many forms that the deal could take, with varying tax consequences.

Oil payment vs. overriding royalty—Assume that the original lease bonus paid for a lease on a quarter section (160 acres) was $16,000 and that because nearby discovery wells have indicated the presence of oil, the lessee can "sell" his working interest, for $500,000, retaining either an "oil payment" of $250,000 payable out of 1/4 of the first oil produced or an "overriding royalty" of 1/16th of the oil to be produced.

If oil is selling for $2.50 per barrel, it will take 100,000 barrels of oil to satisfy the oil payment. Therefore, if the reserves under the property are 1,600,000 barrels, the 1/16th override will produce exactly the same monetary return as the oil payment but because the oil payment is payable out of 1/4 of the oil produced, the oil payment will pay out faster. Moreover, because of the fact that it is payable out of 1/4 of the oil, the entire oil payment can be paid out if there are only 400,000 barrels of recoverable oil. On the other hand, if there are more than 1,600,000 barrels of recoverable oil, the overriding royalty being for the life of the property, it will produce more income than the oil payment.

An oil payment can be payable in either barrels of oil or dollars.[11] If the oil payment is for a stipulated dollar amount, another factor, the future price of oil, must be taken into consideration in weighing

[9] I. R. C., Sec. 117(j).

[10] Greene v. Comm., 141 F. (2d) 645 (C. A. 5th, 1944).

[11] Comm. v. American Liberty Oil Co., 127 F. (2d) 262 (C. A. 5th 1942).

the relative advantages of the oil payment against the overriding royalty. If oil goes up in price, the royalty will be worth more but the oil payment, although having greater security because it will be payable out of fewer barrels of oil, will nevertheless never return more than its face amount.

If after weighing all the factors, the lessee determines that either the oil payment or the overriding royalty would be a satisfactory retention of interest in the property he is about to dispose of, he should then examine the tax consequences. Under the Internal Revenue Code, a transfer of the working interest for a cash payment of $500,000 and a retained oil payment of $250,000 would be treated as a sale of oil in place except to the extent required to satisfy the oil payment.[12] The original "lease bonus" of $16,000 would be allocated between the retained oil payment and the working interest disposed of on the basis of the value of each and the excess of the $500,000 received over the basis allocated to the transferred working interest would be considered to be long-term capital gain if the property had been held for over 6 months[13] and the lessee was not a dealer in oil properties.[14] On the other hand, the Bureau of Internal Revenue has ruled that the transfer of oil and gas property with the retention of an economic interest extending for the life of the property constitutes not a sale but a sublease, even though there is no present intention to develop the property,[15] and where the property has been developed or development is contemplated in the immediate future, the courts have made similar determinations.[16] Thus, if instead of retaining the oil payment, the lessee retained an overriding royalty, the entire $16,000 lease bonus originally paid would be allocated as basis to the retained royalty[17] and the $500,000 cash received would be treated as a "lease bonus" taxable as ordinary income subject to an allowance for depletion.[18]

After production had started, payments made to the holder of either the overriding royalty or the oil payment would be considered as ordinary income from the production of oil subject to either cost depletion or percentage depletion, whichever was the greater.

Taxwise, it would make little difference to the operator of the property whether the interest retained by his assignor was an oil payment or an overriding royalty. In either case, the $500,000 which

[12] I. R. C., Sec. 117 (j); Comm. v.Fleming, 82 F. (2d) 324 (C. A. 5th 1936).

[13] I. R. C., Sec. 117 (j).

[14] Greene v. Comm., 141 F. (2d) 645 (C. A. 5th, 1944).

[15] G. C. M. 27322, I. R. B. 19, Sept. 15, 1952.

[16] Palmer v. Bender, 287 U. S. 551 (1933).

[17] Reg. 111, Sec. 29.23 (m)-10 (a); Murphy Oil Co. v. Burnet, 287 U. S. 299 (1932).

[18] Reg. 111, Sec. 29.23 (m)-10 (a).

he paid would be considered as a capital expenditure,[19] the basis of his acquisition recoverable through depletion, and in either case the payments in satisfaction of the retained interest would be excludable from the operator's gross income, as representing oil not acquired by him.[20] The only difference in tax treatment to the operator would be, that if the retained interest was an overriding royalty, there would have to be excluded from the operator's gross income for the purpose of computing statutory percentage depletion, an aliquot portion of the $500,000 lease bonus, based on the relation of production during the year to reserves at the beginning of the year plus reserves discovered during the year. The gross income upon which statutory depletion is allowed can never exceed the total gross income from the property and inasmuch as the recipient of the lease bonus is allowed percentage depletion on it, an equivalent amount must be excluded from the operator's gross income in the depletion computation.[21]

Participation in Operation of Lease:

If instead of selling the lease, the lessee wishes to participate in its operation, he again has several alternatives each of which has a different effect on his Federal income tax liability.

Use of own capital—If he decides to risk his own capital in drilling and equipping the property, he may elect to expense all of his intangible development costs.[22] If instead, he elects to capitalize intangibles, he has a separate election in connection with intangible drilling costs, where the drilling results in a dry hole.[23] The election with respect to the expensing of intangible development costs must be made in the tax return for the first year in which such costs are incurred and such election is binding for all subsequent years. It covers all properties then owned or thereafter acquired by the taxpayer. Usually, taxpayers elect to expense intangible drilling costs because such costs when capitalized can only be recovered through cost depletion and no tax benefit is realized from capitalized costs when percentage depletion is taken.[24] Regardless of the election with respect to intangible drilling costs, expenditures for equipment must be capitalized and recovered through depreciation.[25] Moreover the election to expense intangibles

[19] Reg. 111, Sec. 29.23 (m)-10 (a); Murphy Oil Co. v. Burnet, 287 U. S. 299 (1932).

[20] Reg. 111, Sec. 29.23(m)-1 (f); Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312 (1934).

[21] Reg. 111, Sec. 29.23 (m)-1 (f).

[22] Reg. 111, Sec. 29.23 (m)-16 (b).

[23] Reg. 111, Sec. 29.23 (m)-16 (b) (2) (IV).

[24] U. S. v. Dakota-Montana Oil Co., 288 U. S. 459 (1933).

[25] Reg. 111, Sec. 29.23 (m)-16 (b) (3) (i).

applies only to expenditures for drilling and not to operating expenses.[26] In a recent ruling the Treasury Department has set out its classifications of items to be expensed and items to be capitalized.[27]

Dry hole contribution, bottom hole money, etc.—Possibly the lessee may receive financial assistance toward the drilling of the well in the form of a dry hole contribution, bottom hole money, etc., from adjoining leaseholders interested in establishing the value of their leases through the results of the test well. It is common practice for the contributors of the assistance to deduct their contributions as expenses and the recipient to reduce his tangible and intangible costs pro rata, whether or not he has elected to deduct intangible drilling expense.[28] The Treasury may take the position that the contribution is additional lease cost to the contributor if the well produces. If it is a dry hole there would appear to be less question as to the deductibility of the contribution as an expense. Of course, if the contributor drops his own leases in the area on the basis of information obtained from either bottom hole or dry hole contributions, the contributions would be deductible as losses.

Use of "oil payments"—Sometimes it becomes necessary to finance either the purchase of oil property or its development through the use of "oil payments." The Bureau of Internal Revenue has ruled that the creation of an economic interest in oil property extending over a life less than that of the interest from which it is carved results in the receipt of ordinary income, subject to the allowance for depletion, to the extent of the consideration received for the interest so created.[29] An exception to this rule is the creation of an oil payment when the proceeds are pledged to the development of the property.[30] No gain or loss is realized by the operator when an oil payment is used to defray development expenses.[31] However, the expenses so defrayed are no longer considered as expenses of the operator and thus cannot be capitalized nor expensed by him. The drilling contractor who receives an oil payment in exchange for drilling a well must capitalize his drilling costs as his basis for the oil payment and may take cost or percentage depletion, whichever is greater, against the proceeds.[32]

Where an "oil payment" is used to help finance the acquisition of

[26] Reg. 111, Sec. 29.23 (m)-16 (b) (3) (ii).

[27] Mim. 6754, C. B. 1952-1, 30.

[28] Detroit Edison Co. v. Comm., 319 U. S. 98 (1943).

[29] G. C. M. 24849, C. B. 1946-1, 66; I. T. 4003, C. B. 1950-1, 10.

[30] G. C. M. 24849, C. B. 1946-1, 66; I. T. 4003, C. B. 1950-1, 10.

[31] E. C. Laster, 43 B. T. A. 159 (1940).

[32] Dearing v. Comm., 102 F. (2d) 91 (C. A. 5th, 1939).

oil property, care should be exercised to see that the transaction does not result in the receipt of ordinary income to the extent of the consideration for the oil payment. If a lessee sells the working interest for $1,000,000 reserving unto himself an oil payment of $500,000 payable out of 60% of the first oil produced and coincident with or subsequent to his sale of the working interest he sells the oil payment to a third party for $450,000, he has received as gross sales price for his entire interest $1,450,000 and if his original cost was $50,000 he has realized a long-term capital gain of $1,400,000, if his original acquisition of the property was at least 6 months prior to the sale[33] and he was not a dealer in oil properties.[34] His holding period for the oil payment dates back to the time he acquired the interest out of which it was reserved.

In a recent case, the U. S. Court of Appeals for the Fourth Circuit, reversing the Tax Court, held that where oil is discovered on a lease, the taxpayer acquires a new property so that when an interest in this newly discovered oil in place is transferred, the holding period dates from the discovery of the oil and not from the date of the execution of the oil and gas lease.[35] It would appear that the court did not take into consideration the fact that an oil and gas lease is a grant of a "bundle" of inseparable rights—the right to explore for oil and gas, the right to develop the property, the right to operate the property and the right to produce oil and gas therefrom for so long as such oil and gas can be produced. These rights are all granted when the lease is executed and when an interest in these rights is assigned the holding period should be computed from the date the rights were acquired by the execution of the lease. Contrary to the holding of the Court, the discovery of oil does not vest any new rights in the leaseholder. Although certiorari was not authorized, it does not appear that the Treasury is following this decision. However, until the matter is settled by legislation or further litigation, it would be advisable not to dispose of interests in producing properties until 6 months after production was established if long-term capital gain is desired or the transaction contemplated requires the favorable treatment accorded to real property held for more than 6 months and used in a trade or business.

The purchaser of the working interest which is subject to the oil payment has no gain or loss on the transaction and although he must bear the costs of lifting the oil necessary to satisfy the oil payment, the tax treatment, based on the

[33] I. R. C. Sec. 117 (j).

[34] Greene v. Comm., 141 F. (2d) 645 (C.A. 5th, 1944).

[35] Petroleum Exploration et al. v. Comm., November 29, 1951, U. S. C. A. 4th Cir. No. 6317.

theory that he never had title to that oil, permits the exclusion of the proceeds of the oil used to liquidate the oil payment from the operator's gross income[36] and allows him to deduct the lifting costs as ordinary and necessary expenditures. However, where the cost of lifting the oil necessary to satisfy the oil payment exceeds the net income from the property, the Treasury will probably take the position that such excess should be capitalized as additional lease cost recoverable through depletion.

On the other hand, if the operator had purchased the entire working interest for $1,450,000 and then had "sold" a $500,000 oil payment to a third party for $450,000, there is grave danger that under present Bureau of Internal Revenue rulings, the $450,000 so received might be considered ordinary income subject to depletion allowances.[37]

There has been some disagreement expressed among oil lease operators over the Treasury rulings with respect to oil payments and it is possible that these rulings may be overthrown or limited by the Courts. However, although the strict application of these rulings can result in severe tax penalties for an incautious taxpayer, they nevertheless can result in tax savings if properly applied. For example, in determining a net operating loss carry-over or carry-back, the excess of percentage depletion over cost depletion must be eliminated from both the year giving rise to the net operating loss and the year to which it is to be carried.[38] For an oil company claiming substantial amounts of percentage depletion each year this adjustment nullifies the benefits of the operating loss carry-over provisions of the Code. The same results can be achieved however, without loss of the percentage depletion deduction, through use of oil payments. For example, an oil company with a net operating loss of $500,000 can sell oil payments for that net amount of dollars. The proceeds of these oil payments are income upon receipt under the Treasury rulings and thus the net operating loss is eliminated. In the following year, the costs of producing the oil necessary to satisfy the oil payments reduce taxable income. Thus $500,000 worth of income is anticipated and a net operating loss not otherwise available is used in full.

"Mining partnership" or "joint venture"—Another method of financing the development and equipping of an oil and gas lease is through the use of a "mining partnership" or "joint venture." The owner of the working interest

[36] Thomas v. Perkins, 301 U.S. 655 (1937); Delacroix Corporation, 13 T. C., No. 107 (1949).

[37] G. C. M. 24849, C. B. 1946-1, 66; I. T. 4003, C. B. 1950-1, 10.

[38] Reg. 111, Sec. 29.122-2.

might transfer an undivided one-half interest in his working interest to one or more joint venturers who would agree to drill and equip the required number of wells.[39] Under such an arrangement, each of the joint venturers would be able to deduct a portion of the intangible drilling costs in proportion to his share of the property. The original owner of the working interest would not be required to include in income the value of his 1/2 interest in the well which was paid for by his joint venturers. Of course, not having paid any of the intangible drilling costs, he gets no deduction for intangible development expense. Such a "joint venture" is required, under the Regulations, to file a skeletonized partnership income tax return.[40] Whenever a joint venture is used in connection with oil and gas transactions, care should be taken to provide in the operating agreement that each joint venturer is entitled to his share of the oil and gas in kind, else the venture may be taxable as an association doing business as a corporation.

"Carried working interest" and "net profits interest"—Two other popular methods of financing the drilling and development of a lease are the use of "carried working interests" and "net profits interests." Although these two methods are essentially similar in economic results, the tax consequences may be quite different. Under the "carried working interest," drilling and development is done under an agreement whereby all of the funds are advanced by one party to the agreement and he is to recoup all of his expenditures from the lease before the other party gets any share. After all expenditures have been recouped, both parties share equally in the lease. The lease owner is never personally liable for any portion of the drilling expenses and if the well results in a dry hole his drilling coadventurer stands the entire loss. On the other hand, if the property is productive, the leaseholder gets no income until the expenditures have been recouped. In a "net profits interest" arrangement, the leaseholder assigns his lease in exchange for an interest in the net profits from the lease, after recoupment of all expenditures. Economically, the receipts by the holder of a 50% "net profits interest" are exactly the same as those of an owner of 50% "carried working interest," particularly where the "net profits interest" is entitled to share in salvage of equipment. For many years, the tax treatment of the "carried working interest" and the "net profits interest" were the same, that is the "carried" participant reported nothing until he received income and then he re-

[39] I. T. 3930, C. B. 1948-2, 126; I. T. 3948, C. B. 1949-1, 161.

[40] I. T. 2785, C. B. XIII-1, 96 (1934).

ported only the amount which he received as gross income.[41] This amount was excluded from the gross income of the operator of the lease. In a recent case, however, the U. S. Court of Appeals, 5th Circuit, distinguished between the "carried working interest" and the "net profits interest," making no change in the treatment accorded the holder of a "net profits interest" but deciding that the holder of a "carried working interest" must report on his tax return his percentage share of all intangible drilling costs and operating expenses and his share of gross income even though he is not personally liable for the drilling costs and expenses and does not receive the income.[42] In other words, under this decision, the parties to a carried working interest agreement report similar to the joint venture, the expenditures incurred by the operator being considered proportionately on behalf of the other party, as though equivalent sums were being loaned to the nonoperator out of which he was paying his share of the costs of development. It is believed that the Court relied too heavily on a previous case, in which one of the parties was being carried in the operation of a commercial enterprise, without realizing the essential difference that in the commercial enterprise there was sufficient intrinsic value in property of the enterprise to insure the repayment of the advances whereas in the operation of oil and gas properties, the repayment is highly problematical, depending upon the existence of oil. Neither the oil industry nor the Treasury Department approve of this decision and its application to existing agreements has been extremely limited. However, until there has been clarification of the proper treatment of a carried working interest by legislation or further litigation, care should be exercised in the wording of any agreement setting up any venture in which one party is not liable for his share of development costs except out of production.

In both the "carried working interest" and the "net profit interest" all participants are entitled to percentage depletion as each participant is deemed to have an economic interest in the oil and gas in place.[43]

While there is no doubt that where a "net profits interest" or "carried working interest" arose out of previous ownership of oil and gas in place, the holder thereof is entitled to depletion, a recent case held that where such interests were acquired by persons never

[41] Burton-Sutton Oil Co. v. Comm. 328 U. S. 25; Kirby Petroleum Co. v. Comm. 326 U. S. 599.

[42] Commissioner v. J. S. Abercrombie Co. 162 F (2d) 338.

[43] Burton-Sutton Oil Co. v. Comm. 328 U. S. 25; Kirby Petroleum Co. v. Comm. 326 U. S. 599.

previously having any other interest in the property, no depletion is allowable. This holding appears to be erroneous. The Supreme Court has held that where a person must look solely to the oil and gas in place to recoup his capital investment, such person has an economic interest in the property,[44] and it would appear to be immaterial whether the capital to be recovered represented services or property exchanged for the interest in the oil and gas in place, a cash purchase, or a reservation from a previous larger ownership.

Worthless Leases:

When a nonproductive oil and gas lease becomes worthless, a tax deduction in the amount of the cost or "lease bonus" paid for the lease plus capitalized legal fees, etc., may be taken. Often a question arises as to when a lease becomes worthless, particularly if an identifiable event happens in one year but the next "delay rental" payment date is not until the next year. The Bureau of Internal Revenue often refuses to allow deduction for a "worthless" lease because the taxpayer is still paying delay rentals on the property.[45] On the other hand, a taxpayer cannot postpone the taking of a loss which will not give him tax benefit merely by paying a nominal delay rental and thus continuing a worthless lease in force for another year. If a lease is purchased on speculation and test drillings on adjoining leases indicate that it is worthless so that delay rentals will not be paid when next due, it appears advisable for a taxpayer to immediately divest himself of ownership in the lease by executing a release and forwarding it to the lessor, thus putting the cessation of ownership and the identifiable event in the same tax year and avoiding any chance of the loss being disallowed.[46]

Exchanges of Interests in Oil and Gas:

Under state law and for purposes of Federal excise taxation, interests in oil and gas in place which extend for the life of the property are deemed to be real property. These include royalty interests, overriding royalties, working interests in developed or undeveloped leases, etc. The Internal Revenue Code provides that no gain or loss shall be recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.[47] It has been held that

[44] Burton-Sutton Oil Co. v. Comm. 328 U. S. 525.

[45] Appeal of A. L. Huey, 4 B. T. A. 370 (1926); A. T. Jergens Trust, 22 B. T. A. 551 (1931).

[46] U. S. v. White Dental Mfg. Co. 274 U. S. 398.

[47] I. R. C. Section 112 (b) (1).

transfer of an undivided interest in oil and gas in place for an undivided interest in an improved city lot, being an exchange of real property for real property, was solely in kind and therefore tax free.[48] An early nonacquiescence of the Commissioner in the Tax Court decision so holding has recently been withdrawn[49] and the Commissioner now recognizes the tax-free nature of all exchanges of oil and gas interests for other oil and gas interests or other real property with the exception of an exchange involving an oil payment.[50]

Despite the fact that an in-oil payment is treated by many states as an interest in real property, it is the Commissioner's contention that an exchange of an oil payment for other types of interests in oil and gas properties is a taxable exchange. This contention has been supported by the Courts, but one case is currently on appeal to the 5th Circuit.[51]

In exchanging producing property for producing property it may be advisable to exchange depreciable property for depreciable property and depletable property for depletable property rather than to make one all inclusive exchange to avoid a realignment of basis.

Conclusion:

This brief article covers but a portion of the field of tax problems incident to the acquisition and disposition of interests in oil and gas properties but it should serve to point out the necessity for a review of the tax consequences of a transaction before the transaction is consummated.

[48] Comm. v. Crichton (CCA-5) 122 F. (2d) 181.

[49] I. R. B. 1952-10-13816.

[50] I. T. 4093; I. R. B. 1952-17-13894.

[51] Bandini Petroleum Co. Tax Court Memo Dec. Oct. 18, 1951; Midfield Oil Co. 39 B. T. A. 1154; Kay Kimbell 41 B. T. A. 940.

A Few Random Observations About the Oil Industry

By A. H. Degener
(Tulsa Office)

The operations of the oil industry are so inextricably interwoven with taxes—income taxes, gross production or severance taxes, ad valorem taxes, transportation taxes, sales taxes, etc., just to mention a few—that it is virtually impossible to write or talk about the industry without dwelling at some length on the subject of taxes. There are, of course, other extractive industries which are faced with many of the same type of tax problems, but, inasmuch as the oil industry's plant facilities (including its marketing facilities) are scattered over such wide areas, it is doubtful whether any of the other industries are so directly and so largely affected by taxes as is the oil industry. Not only are the industry's daily operations inescapably affected by taxes of one sort or another, but even the principles governing the recording of its investments in plant facilities are dictated in a large measure by tax implications.

However, notwithstanding the foregoing, and especially since the subject of income taxes is being dealt with in another article in the Journal, I shall attempt to limit my observations principally to nontax features which may be of interest to those not generally familiar with the operations of the oil business.

As in most industries, the oil industry has developed its own jargon of descriptive terms and phrases. In the stock brokerage business you have bulls and bears, and long and short positions; in the textile industries you have woofs, warps, and mules; and in the oil business you have cat crackers, headache posts, floating roofs, horse heads, Christmas trees, mouse traps, dog houses, etc. These terms are defined below:

Cat Cracker—a refining unit which heats and cracks liquid petroleum in the presence of a catalyst.

Headache Post—a post set under the walking beam at one side of the derrick floor; it is said that in the earlier days the driller leaned on this post when escaping gas gave him a headache.

Floating Roof—a roof on special storage tanks which floats upon the oil; its purpose is to reduce evaporation losses and minimize the chances of fire.

Horse Head—a device located on the end of the walking beam of the well pumping unit.

Christmas Tree—the complicated arrangement of gauges, valves, nipples, and other

connections at the surface of an oil well used to control and direct the flow of oil.

Mouse Trap—a cylindrical tool which is used to fish out small objects that may be lost in a well.

Dog House—a building provided for drilling crews and pumpers in producing fields.

Even the commonly understood definition of a warehouse loses some of its significance in the oil business, especially in the production field. There a warehouse, instead of being a building often many stories tall, is usually little more than a fenced-in area in which are stored "strings" of tubular goods, such as casings for oil well, line pipe for gathering systems, etc. Pumps, pumping engines, valves, fittings, etc., are, of course, usually stored in housed-in areas.

Plant Facilities and Inventories:

The plant facilities of an oil company, other than refineries, gasoline plants and tank farms, may be scattered over many thousands of acres of land in a number of states, depending, of course, upon the size of the company. Some of the facilities for the production of crude oil are even located in river beds and in the submerged lands adjoining our coastal oil producing states.

Inventories of crude oil will be found in the same general locations as the producing properties. However, from the viewpoint of the auditor, the verification of the quantities thereof is not as stupendous an undertaking as it might seem. The greater portion of crude oil inventories will usually be found in tank farms of the gathering systems and in storage facilities at refineries since the oil is withdrawn from the lease tanks into pipe line gathering systems at frequent intervals. Crude oil is, of course, also transported by trucks, tank cars, and barges.

The pipe line gathering systems and trunk lines of oil transportation companies cover many hundreds of miles; for example, pipe lines carry crude oil from the Mid-Continent producing states to refineries located in the metropolitan areas of such cities as St. Louis, Chicago, Toledo, Cleveland and Detroit. A series of booster pumps along the lines assist in the delivery of the oil.

No attempt will be made to describe the complex operations which take place in the process of extracting gasoline and many other products from crude oil. Those who have seen oil refineries have undoubtedly observed the maze of pipes which tie together the various towers, etc., in a sort of Rube Goldberg fashion. Included in a modern refinery may be a catalytic cracking plant (which dates back only to 1936) in which, through the application of a catalyst, the molecular structure of oil is changed, resulting in the recovery of larger quantities of gasoline. There may

also be a polymerization plant which produces gasoline of a high knock rating for blending with straight-run or "cracked" gasoline to meet the demand for high octane gasoline. To quote from *American Petroleum Refining* by H. S. Bell, this process, in a restricted sense, accomplishes "the linkage of light gaseous hydrocarbons to a liquid product whose boiling point is within the gasoline range." There may also be an alkylation plant which is presently the principal source for the production of blending agents for producing high octane gasoline, such as is used in airplanes.

Billing Procedures:

The members of the oil industry generally do not render invoices covering sales of crude oil. Instead, the purchasers (which may be another oil producer, a refinery, or a pipe line company) render monthly statements to the vendors showing the number of barrels of oil purchased and the aggregate purchase price thereof. These statements are prepared from pipe line run tickets which are signed by representatives of both the buyer and seller at the time the oil is run from the seller's tanks. Copies of the run tickets are, of course, furnished the sellers so that they can determine and accumulate the amount of their sales as they occur.

I have been unable to determine the basis for this method of accounting for sales of crude oil. However, I suspect that it may date back to the days when the average producer of crude oil lacked the facilities for doing his own billings; perhaps the only paper he owned was the paper bag in which his spouse carried home the groceries.

A considerable amount of clerical effort is involved in processing the run tickets, which show the gauge readings in feet and inches at the beginning and end of the runs, the specific gravity of the oil, etc. The gauge readings must be translated in terms of barrels, the indicated volumes must be adjusted to a 60 degree temperature basis, and, except in limited areas where oil is purchased at a flat price regardless of gravity, the gravity readings must be adjusted to the equivalent gravity at 60 degrees.

Partnership or Joint-Interest Operations:

Perhaps not generally known is the fact that a substantial portion of crude oil production is carried on under so-called partnership or joint-interest arrangements in which two or more companies own a share in the working interest of a lease. One of the partners is designated as the operating partner and it is usually his responsibility to develop and operate the property.

There are, however, many types of arrangements under which the development of the property is financed. For example, the cost of developing and equipping the property may be borne currently in the proportion of each partner's interest; the operating partner may advance the entire cost under an arrangement whereby he retains the full amount of production from the working interest until such time as he has been reimbursed for the amount of the advances which he "carried" on behalf of the other partners; or one or more of the partners may agree to contribute only a fixed sum toward the development of the property regardless of the ultimate cost thereof. These are only a few simple illustrations; many more complicated and involved arrangements actually are in operation.

The operating partner usually is charged with full responsibility for the operation of the property. Generally, he pays all the operating expenses and charges each of the partners with his proportionate share thereof; he collects the gross proceeds from the sales of production; pays the gross production and/or severance taxes; pays the lessor or royalty holder his share of production (usually an eighth); and finally, remits to his partners their share in the production from the working interest. These steps can, and often do, involve a tremendous amount of clerical and accounting effort. In many instances the agreements between the parties at interest contain provisions calling for periodic audits by independent public accountants. There may be not only a number of partners in the working interest, but it is not uncommon to find that the royalty holder has sold fractional shares in his interest to others, each of whom must be paid his proportionate part of the amount due the royalty holder.

The size of the company or the amount of its share in the working interest has no particular bearing on the matter of determining who will be designated as the operating partner. There is perhaps a fifty-fifty chance that the company serving as the operating partner may be the smaller of the companies involved.

Such partnership arrangements have undoubtedly played an important part in the development of the oil industry. They have undoubtedly enabled many of the smaller companies to develop properties which they would not otherwise have been able to develop due to lack of adequate working capital, while on the other hand, they have served the interests of the larger companies in their efforts to find sources of crude oil for their refineries.

Exchange of Production:

Another interesting feature in connection with the operation of

oil companies involves the exchange of crude oil. For example, Company "A" may have production in Oklahoma in excess of its refinery capacity, while in Texas its production of crude oil may be less than its refinery capacity. Company "B", on the other hand, may have the reverse situation. Their common problem is often solved by exchanging production, that is, by delivering crude oil to each other's refineries. In actual practice, of course, the solution is not always so simple—a sort of chain reaction may be set off involving a number of companies, each interested in solving a similar problem, before the problems of "A" and "B" in Oklahoma and Texas are solved.

Dry Hole Contributions:

Arrangements for the payment of dry hole contributions are sometimes entered into in situations where the holders of leases in an unproven area agree to pay the holder of another lease in the same area a specified sum of money in case the well drilled by him should prove to be commercially unproductive. The prospective contributors are willing to assume the risk having to pay part of the cost of a dry hole on another's property because the drilling of a successful well in the area tends to prove the value of their own leases. No contributions are, of course, made in case the well is commercially productive.

Finding New Sources of Oil:

Many millions of dollars are spent each year by members of the oil industry in geophysical exploration efforts to find new sources of oil. Much has been accomplished in this respect since the days when the divining rod and other forms of "doodlebugs" were used to locate oil as well as water. However, despite substantial improvements in the art, there remains yet to be developed a direct, "sure-fire" method of discovering the presence of oil. Drilling a hole into the ground is still the only sure way of finding crude oil.

Oil engineers consider the seismic method the most reliable medium for locating possible oil-bearing sands. Charges of dynamite are exploded in previously drilled holes, from a few feet to several hundred feet deep, to set off miniature earthquakes, and reflection seismograph instruments are used which enable the operator to record the time it takes for the sound waves to travel to a certain horizon and back to the surface. This data permits the geophysicist to plot the subsurface structures, and if his interpretations indicate that the horizons are of the nature which may contain oil, a test well is likely to be drilled.

Efforts to Increase Oil Recovery:

The oil industry, in relatively recent years, has been successful in increasing the recovering of oil

through so-called secondary recovery and pressure maintenance operations. Oil engineers have known for many years that generally less than 50 percent of the oil actually present in the oil-bearing sands is recoverable under normal operating methods. These sands can perhaps be compared to a water filled sponge, which must be squeezed to force out the water.

Both methods involve the injection of water or gas, or both, through input wells into the oil-bearing sands under carefully developed patterns which are designed to drive the oil to producing wells. The input wells may be wells which were originally drilled as oil production wells, or they may be drilled especially as input wells.

Broadly speaking, the two methods differ from each other principally in the matter of timing and the amount of area covered. Secondary recovery operations may cover only relatively small areas and are usually undertaken at a time when the operation of the wells is no longer considered commercially profitable under normal operation methods. Pressure maintenance operations, on the other hand, are undertaken *before* the natural underground energy which drives the oil to the producing wells is exhausted. As the name implies, the purpose of pressure maintenance operations is to maintain the normal underground pressure by filling in the void spaces in the sands resulting from the withdrawal of the oil.

The secondary recovery type of operation is the older of the two methods. Experience has demonstrated that such operations actually achieve their intended purpose. To cite an actual example, the daily production from a lease about two years after secondary recovery operations had been undertaken was about twelve times the recovery at the beginning of such operations.

Since a pool or reservoir of oil is likely to underlie more than one lease, both types of operations may involve unitization arrangements. Under these arrangements the holders of the leaseholds and of the royalty interests pool or unitize their respective interests and operate the property as a unit, each sharing in the production on an agreed basis regardless of the particular parcel of land from which the oil may be withdrawn. The consummation of these agreements may involve a tremendous amount of effort on the part of the sponsors since the various interest holders must be convinced that their interests are being properly protected. For example, the unitization of approximately 47,000 acres of land in the State of Texas involved 250 separate tracts of land and several thousand royalty owners, besides the holders of the working interests.

Oil engineers estimate that, as a result of pressure maintenance

operations, the ultimate recovery from the 47,000 acre project over the next 40 years will be increased from the 450,000,000 barrels expected to have been recoverable under normal operating methods to 1,180,000,000 barrels. Priced at the approximate current average price of crude oil, such additional recovery of some 700,000,000 barrels of oil has a sales value of almost two billion dollars.

Conclusion:

As one who has driven "hot-rods" of one sort or another since 1914, I believe I can safely venture the opinion that the quality of gasoline presently available is far superior to that available some 30 or 40 years ago. This improvement has been accomplished largely through technological improvements in the art of producing and refining crude oil without any material increases in the base selling prices of gasoline, despite rather substantial increases in costs generally. In this connection I submit the following table, compiled from *Petroleum Facts and Figures* published by the American Petroleum Institute, which shows the simple average (at five-year intervals) of the first-of-month service station prices in 50 representative cities in the United States during the period from 1920 to 1950. It will be noted that the average service station price—after eliminating federal, state and local taxes—was approximately the same in 1950 as it was in 1925; and, what is even more significant, that the price in 1950 was only about two-thirds the price in 1920.

	Average service station price	*Federal, state and local taxes included*	*Base price of gasoline*
1950.....	$.2676	$.0668	$.2008
1945.....	.2050	.0602	.1448
1940.....	.1841	.0566	.1275
1935.....	.1884	.0529	.1355
1930.....	.1995	.0379	.1616
1925.....	.2220	.0211	.2009
1920.....	.2983	.0009	.2974

The tax column, I believe, presents its own story. As I said earlier, it is virtually impossible to write or talk about the oil industry without dwelling at some length on the subject of taxes.

Accounting for the Cotton Merchant

By J. F. Stuart Arthur

Many changes have taken place in the cotton merchants' business in the last thirty to forty years, some of those changes being fundamental and relating to the deterioration of economic position held by the commodity with which that merchant deals. These changes not only arise from the impact of competitive fibres but also from the altered position of the United States' cotton crop in relationship to the world's crop, and from the fluctuations which have taken place in the volume of United States cotton exports, and the insecure basis on which those exports presently rest.

In the cotton season 1911-12, seventy per cent of the world's cotton crop was produced in the United States, and of this crop more than seventy-five per cent was sold to foreign countries. In the season 1934-35, the world production totaled 22,612,000 bales, of which the United States produced 9,567,000 bales, or forty-two per cent of the total, and exported 4,767,212 bales, or fifty per cent of the American crop.

During the season to July 31, 1952, exports of cotton from the United States were some 5,515,000 bales out of a total domestic crop of some 15,071,000 bales, that is, barely thirty-seven per cent. The United States crop for that season was almost fifty-three per cent of a total free world crop of some 28,500,000 bales.

Now we have a United States crop as of March 20, 1953, of 14,949,107 bales, and one has seen recent authoritative estimates which indicate a United States usage of nine and six-tenths million bales, and estimated exports of three and four-tenths million bales (actually as of March 16, 1953, 2,153,747 bales in comparison with 4,357,862 bales for the same period of last season). This would leave a domestic carry-over of 4,800,000 bales, as compared with a carry-over of 2,800,000 bales for the 1951-52 season.

Thus, in the intervening years between those immediately preceding the active hostilities of the first World War and the present year, the position of the U. S. cotton situation has changed greatly and with that has changed what the cotton merchant does and what he has to contend with in his business and, in consequence, his accounting procedures have become more complex and therefore, should be more detailed.

Before the first World War, cotton could be considered a cash

commodity, involving not too many technicalities of purchasing and marketing and, as a result, with limited indirect obligations in its handling.

Two World Wars, intervening international financial crises, a world-wide depression, destruction or impoverishment of the greater number of the best foreign customers of the United States, and the increase and spread of government controls over the free flow of economics in every so-called civilized country (which here and in Britain now may be partially slackened), have made each enterprise dependent on foreign trade—and most certainly the cotton merchant—require greater care and greater consideration in its operations and, to have a sounder basis for that, its accounting should be more precise.

Before proceeding farther, it might be well to define what one has in mind by the use of the words "Cotton Merchant." By that designation it is meant to indicate one whose business is that of the first actual wholesale dealer in the chain of marketing the cotton crop from the producer to the ultimate fabricator of the fibre. Some designate themselves "spot cotton merchants," "spot" having the meaning of "actual," some designate themselves "cotton buyers and shippers," some "cotton merchants and exporters," with perhaps the majority using the term "cotton merchants." The function of each is that of a middleman who purchases, for his own account, the cotton farmers' crop for the purpose of ultimate sale to domestic spinners or to foreign buyers or spinners.

Living as we do in Texas, we must all be reasonably familiar with the general methods of the purchase of cotton from the farmer or from those who may have first acquired the producers' crop, and we all know in general the season of the year during which the crop is purchased, and the fact that this takes place in a limited number of months, generally from August in a given year. The crop must be acquired, often over an extended territory, it must be concentrated and stored in compresses or warehouses until the proper time comes for shipment to the ultimate consumer. As shipment dates are spread more evenly over the year than are purchases, the merchant must be prepared to hold his purchases in stock for some considerable period—relieving the producer of that necessity, and providing the domestic spinner or foreign buyer with a market to which he may turn to obtain his requirements, concentrated in suitable localities and properly classified as to "grade" and "staple." In effect then, the cotton merchants' function is one of accumulation and classification of the cotton crop for the benefit of the ultimate fabricator, and of holding the crop, as

an intermediary, providing the producer with a more immediate cash market and serving the fabricator with a more convenient buying market.

The risks of a business such as described are evident, and the increasing need for considerable funds, either as the investment of the operating merchant himself, or from borrowings secured by stocks of cotton or by appropriate documents while the cotton may be moving to its point of sale and before reimbursement is received, is apparent. More so is this the case at the present time when a glance at current statistics shows that the current price of middling 15/16 inch cotton may be fluctuating around $165.00 per bale compared with $100.00 nine years ago and $45.00 fourteen years ago.

One cannot avoid making note of the U. S. Government's actions and regulations in support of prices to be received by the farmer for his crop, and in extending loans to farmers on the crop, thus introducing itself into the economy of the situation as a massive and all powerful intermediary and financier. The cotton merchant must include those facts in his considerations, and the effect is felt also on his accounting procedures. True, often this governmental intervention may tend to narrow the fluctuations in price and may create a government pool of stocks to which access may be had later, but the converse of that may be that certain cotton is held off the market when sorely needed, and later may be dumped by procedures which involve subsidies or other artificial expedients to move, and generally in the final analysis at the taxpayers' expense.

It will be seen that the cotton merchant combines the functions of purchaser, classifier, merchant-banker and broker. Whether he has been amply recompensed for these duties involving capital, skill, and risk, may be a matter of personal opinion. However, it is of interest to look at the following per bale figures relating to more recent operations of cotton merchants, which it has been possible to compile from actual knowledge of the final results of a not inconsiderable volume of gross sales and total bales sold.

As shown by these compilations, net results for the 1951–52 season were disappointing in comparison with many previous years. For the 1951–52 season gross income was $212.79 per bale of sales and net income before federal income taxes which, after all, is a cost of doing business, amounted to $1.91 per bale. Similar figures for 1950–51 were $221.63 and $2.84 per bale, respectively. Thus, on gross income the net income before federal income taxes was .90% for 1951–52, and 1.28% for 1950–51. Assuming, which is not the case, that each of the merchants included in the group was subject to federal income tax

on the book income at corporation rates, the percentage of net return on gross sales would be .42% for 1951–52, and .60% for 1950–51. Not a very extraordinary return for effort, skill, and risk, surely.

As was noted previously, prior to the first World War cotton could be considered a cash commodity, it was bought and sold at a fixed price, the greater volume of the business was for prompt shipment and the protective operation of hedging for the foreign buyer was undertaken by that buyer himself. Matters are now changed, the cotton merchant more often than not has a year-round business, with seasonal peaks and valleys of course, but seldom is his inventory practically liquidated or is his forward commitment position reduced to a negligible situation, as once may have been the case, and now the cotton merchant as middleman takes the risks for both fabricator and producer.

The matter of hedging should now be considered, in so far as one not a cotton man can undertake. A dictionary definition of "to hedge" is "to safeguard one's self from loss on a bet or speculation by making compensatory arrangements on the other side." A "hedge," as the term is used in the cotton business, is a counterbalancing transaction of future contracts against actual cotton. The counterbalancing transactions involve the purchase or sale of a given quantity of cotton at a fixed price in so far as the futures market is concerned, in order to offset, respectively, the sale or purchase of a certain number of bales of actual cotton at a fixed price. Hedging thus is the means by which a cotton merchant endeavors to limit his risk in the purchase and sale of cotton, and this limitation of risk in the fluctuations of the price of cotton places the cotton merchant more nearly, but not exactly, in what should be his true position, that is, one of a broker. The cotton merchant uses the medium of the cotton "futures" market to pass on some portion of his risk to others who have opposite risks or to the speculator in general. When a cotton merchants buys actual cotton and does not sell it at once, he sells "futures" to protect himself against a decline in price, and when he sells actual cotton and does not buy it immediately, he buys "futures" to protect himself against an advance in price.

There are some further definitions which it is appropriate to cover before going into the matter of the cotton merchant's accounting procedures.

"Futures" to a cotton merchant are contracts for the future delivery of cotton, the contracts being made through a broker, a member of one of the organized exchanges, The New York Cotton Exchange, and The New Orleans Cotton Exchange being the ones of importance. Under normal world conditions futures trading in cotton is carried on in

exchanges in foreign countries, but as is well known normal conditions do not exist presently and the most celebrated of cotton exchanges, that of Liverpool, England, remains closed as a result of the misguided actions of the late socialist government of Great Britain. Hopes, however, are becoming stronger that if sterling convertibility can be achieved, the Liverpool exchange will return to its previous prominence.

Hedging, as a method of trade insurance, permits the cotton merchant to limit his risk from market fluctuations, by combining transactions in actual cotton and transactions in contracts for the future delivery of cotton, and enables him to maintain a balance between the total of his sales and the total of his purchases. This procedure controls the merchant's risk as to market fluctuations but, as will be seen later, it does not control his risk as to the total price of cotton.

The term "forward sale" is meant to designate a valid and enforceable contract covering a sale by the cotton merchant of a given number of bales of cotton for shipment at a specified future time.

The term "forward purchase" designates a valid and enforceable contract under which the merchant contracts to buy a certain number of bales of cotton for delivery to him at a specified future time.

The term "on call" is used to qualify a forward sale or a forward purchase when the contract is not definite as to the price to be paid for the cotton involved in the contract. Alternatively, the word "provisional" may be used, so that one may speak of a "provisional sale," or an "on-call sale." If the price to be paid for the cotton is a definite price per pound, then the contract is termed "fixed." The buyer of cotton, whether it be the merchant or the spinner, may wish to avoid the hedging of certain contracts, and in that case he will buy his cotton "on call." The contract will then be entered into for the delivery of the cotton with the price per pound to be paid specified as a certain number of points "off," that is less than, or a certain number of points "on," that is greater than, the price of cotton in a stipulated future month, as quoted, on the day the price is, fixed, or "called," on such one of the recognized cotton exchanges as is specified in the contract. In determining the price of actual cotton or of cotton "futures," one point is equal to one hundredth of a cent.

The term "basis" as used in the cotton business designates the relation between the price of cotton futures contracts and the price of actual cotton. If actual cotton is selling at a higher price than the futures contract it is said to be selling at a "premium," and conversely, if it is selling at a lower price it is said to be selling at a "discount," cotton selling at a premium being quoted at so many points "on" the

future month specified, and cotton selling at a discount being quoted at so many points "off" the future month. A number of elements enter into the consideration of "basis." In the first place, there is the difference to be recognized between the quality and length of the cotton being considered and the standard established as the basis for "futures," namely cotton described as middling 15/16 inch cotton. Then there is the premium which the price for delivery of actual cotton, all of the given character quoted in the sales contract, and at the point of destination specified, should bear above the price for the contract for future delivery on which numerous grades may be tendered. Basis is also affected by the available supply and the demand at various seasons of the year, or from year to year, in respect of the various grades and staples of cotton in which trading is being undertaken.

Having thus mentioned what may affect the matter of basis, it will be observed that the cotton merchant may limit his risk with respect to market fluctuations by means of his futures transactions, but he does not have the machinery of the futures market to provide him with a hedge in the matter of basis fluctuations. It is not possible to trade in actual cotton and not find that the relation between the price of that cotton and the price of futures widens or narrows with the varying conditions of the market.

The terms "grade" and "staple" were mentioned above and if one disposes of these two definitions one can proceed to consider that most important aspect of the cotton merchant's business, namely, what is termed his "position."

"Grade" as applied to cotton is used to designate the character of the cotton with respect to its color and the amount of impurities, such as pieces of broken leaf, contained in the cotton, and the word "staple" is used to designate the character of the cotton with respect to the length and strength of its fibre.

Cotton is classified in accordance with its grade and staple, the classification being based on comparison with government standards, "middling" being the basic grade of American cotton, and 15/16 inch being presently the basic staple length.

As noted previously, the cotton merchant's use of the machinery of the futures market is to hedge his purchases and sales of actual cotton with sales and purchases of contracts for the future delivery of cotton. In so doing the merchant may be "long" of actual cotton, that is, he may have purchased more actual cotton than he has sold, and he may be "short" of futures, or the reverse situation may exist. The situation of the merchant, with respect to his actual cotton purchases or commitments to purchase, with respect to his actual cotton sales or commitments to sell, and with respect

to his protective futures contracts, is termed his "position."

The various elements to be considered in establishing the merchant's "position" will include one or more of the following:

On the "long" side, the elements are:

(1) Inventory of cotton on hand.
(2) Provisional shipments (i.e. cotton shipped "on call").
(3) Fixed forward purchases.
(4) Long futures.
(5) Unfixed forward purchases (i.e. call purchases not received).

On the "short" side, the elements are:

(6) Fixed forward sales.
(7) Provisional purchases (i.e. cotton received "on call").
(8) Short futures.
(9) Unfixed forward sales (i.e. call sales not shipped).

In the foregoing tabulation, items (1) to (4) inclusive, on the "long" side, and items (6) to (8) inclusive, on the "short" side, will give the merchant's position with respect to market risks, termed his "market position." Items (1), (3), and (5), on the "long" side, and items (6) and (9) on the "short" side, will give the merchant's position with respect to basis risks, termed his "basis position."

The foregoing summary tabulation may be used only in developing the merchant's net position as to market or basis risks, without any regard being given to months of stipulated delivery or the grade and staple of cotton to be delivered or received. Further, inasmuch as cotton is bought and sold based on prices per pound of cotton, the bale being merely the package, the foregoing noted tabulation, if stated in bales only, will require adjustment for average weights experienced in so far as all elements, except the long and short futures, are concerned.

It seems to be highly desirable that the merchant amplify these summary position statements so that not only is the "net" position developed, but also is the position with respect to the various months of marked risk, and the basis position with respect to the various grades and staples involved in the actual cotton contracts. It can be seen readily that a practically balanced market position may exist, and yet this condition may be the result of an excess of "December" longs being balanced by the total of excess shorts in "January" and "March." Similarly, excess sales of middling inch cotton cannot be said to be balanced by an excess inventory and purchase commitments of low middling 15/16 inch cotton.

In contrast to the situation in the majority of businesses, assuming that the proper application of inventory values is required, where at least approximate inventory amounts are under accounting control, and periodic accruals are maintained, the drawing of a trial balance from the financial records

of a cotton merchant and its classification into balance sheet and income statement items gives little information of value as to financial position or the results of operations. Only at such time, for example, at the close of a season, when a complete liquidation of inventory and open position items has been effected, are the financial records of a cotton merchant complete. This condition of complete liquidation, one can be sure, is rare if not entirely nonexistent. Periodic trial balances are of little value, and at interim periods gross income, cost of sales and the effect of open contracts are not of final record in the financial accounts. The most important elements of the business, the ones which very often may be the cause of heavy loss, are not of record in dollar amounts until full consideration has been given to the amount of the merchant's inventory and to all the elements of his position. It is true that most cotton merchants do prepare interim statements during the course of a season, by applying to the results shown by their financial records, the computed valuations for inventory, open position elements, and not by any means forgetting the possibility of liability for weight and grade claims which may be presented by the merchant's customers. However, unless great care is taken in the compilation of such interim statements, and if the merchant's inventory is relatively large or his future position extended or unbalanced, the results shown may be at great variance from the results arrived at when the season is closed, say, at the end of June or July.

The basic accounting records required for the cotton merchant are not in any way greatly different from that of any other trading—not manufacturing or extractive—enterprise, and may be maintained either in the old fashioned way by hand or more modernly by machine kept methods, with reliance on punched-card accounting systems by preference, if there is a considerable volume of transactions. There seems then no particular need to describe such basic records.

General ledgers, subsidiary or trade ledgers, cash receipts and cash disbursement records, records for control of cotton documents in process of collection, sales records, purchase records, and records to control freight paid and freight claims recoverable, and to account for claims receivable from customers, or to be made against those from whom the merchant has bought cotton, may be of routine type, with such amplifications as may be required to give the particular merchant such additional information as he may desire. For example, the matter of claims on purchases may be correlated not only with the particular purchase, the season of the year of purchase, the locality of purchase, the cotton

buyer involved, whether a salaried employee or a commission buyer, the actual country seller of the cotton, and the character of the cotton involved. The purchase record might contain much of the foregoing information and would provide information in the case of a provisional purchase as to the month, date, and price of fixation, when such is effected.

Similarly, sales records would give information as to the total contract involved, terms and periods of shipment, details of reimbursement, the broker, if any involved, the data as to fixation if the sale is "on call", and the record as to claims arising from the sale and the final disposition of such claims.

In records, in which entries are made for sales or purchases of cotton, special columns are provided for recording the number of bales of cotton involved, and in such supplementary records as are used outside the regular financial records, this quantitative control should be carried further to record the actual weight in pounds of the cotton involved in the transaction.

Purchase records will show bale numbers, and sales records will show not only the sales invoice numbers but also the "mark" or shipping designation.

With the use of a punched-card system installation a wealth of valuable data can be accumulated.

Two further very important records which the cotton merchant must keep, if he is to avoid the inquisitive attention of the representatives of the Commissioner of Internal Revenue, are those for record and control of his physical inventory of cotton, and those in which the merchant keeps record of his "position". The stock or inventory record is most conveniently kept through the medium of punched-card accounting, this method providing a great degree of elasticity, and it has been noted that in a number of instances where the merchant's volume of business might not justify such an arrangement for himself alone, a pooling arrangement for such facilities with one or more merchants similarly situated has worked satisfactorily.

The future position record which may be termed the "Position Book" or the "Long and Short Book" is used for keeping a record of the merchant's commitments under his contracts to purchase or to sell actual or "spot cotton", and his contracts in connection with "futures" or the protective contracts for the future delivery of cotton. This record, maintained from day to day, and brought up to date each time the situation is changed, should indicate to the merchant his net market position and his net basis position. If the record is amplified sufficiently, it should be sufficient to indicate the position with respect to the various months of "futures"

involved, and the futures months on which purchases and sales have been fixed. Because of the critical importance of the "Position Book" in the conduct of the cotton merchant's operations, it is very important that the balances developed by the record should be proved by a frequent inventory of the detailed data as to open contracts which should exist in the supplementary records as to purchases, sales and futures contracts.

Other records, or expansions of previously noted records, will be required to show the location as to compresses and warehouses of the merchant's inventory of cotton, the details of the cotton in the inventory, and of cotton documents in transit for collection, some of which may be pledged as security against obligations to banks.

Appended are two financial statements showing a typical balance sheet of a cotton merchant and a typical income statement, with the items of expenses shown in some detail.

In so far as asset, liability, income or expense designations, such as cash, trade accounts receivable, accrued expenses, gross sales, office and general expenses, are concerned, there is no need to discuss them specially for the case of a cotton merchant. Consequently, attention is directed more particularly to those items which are more or less peculiar to the cotton merchant's financial statements.

It is appropriate to admit that the specimen financial statements have been somewhat simplified to exclude certain items which are set out in some statements one has seen. Brokers' accounts could be shown to set out market differences involved with an adjustment noted for margins and closed account balances, or with those items indicated parenthetically. However, there seems to be no point in that, if the statements are set up to show, not a net amount of the combination of all market differences, but the true balances which would attach on a liquidation as of the date of the balance sheet, and with proper regard to the debtor and creditor relationship, the credit risks which may be involved, and the demands for payment which may arise. This observation would apply to the presentation of the amounts included in market differences, if the net amounts applicable to each debtor or creditor are properly marshalled. Naturally, notes to the financial statements are in order, if unusual circumstances exist relating to complexity of pledge of assets, security for liabilities, or contingent liabilities requiring full description to be covered properly. However, that situation is not peculiar to the financial statements of a cotton merchant and consequently, is considered outside the bounds of this discussion.

Some minor items might be given in greater classification, such as the

subdivision of current claims as between those already filed against railroads, from what may be expected to be recovered from freight bills on hand, and the segregation from insurance refunds to be received.

There might be a country-by-country classification of trade receivables and payables, and accrued claims payable, which could be undertaken, but that has no great merit at this time, and certainly might be invidious. It is remembered that during the years, when the outbreak of the second World War was approaching, and more particularly during the period of hiatus from 1939 until almost the end of 1941, it was considered by some to be quite important to disclose whether or not receivables and payables were related to domestic accounts or to continental European, British, Japanese or Chinese accounts.

It is important if any of the cotton in the inventory is not American cotton, or is not in domestic storage, to so indicate.

In the ascertainment of a cotton merchant's financial position and the results of his operations, it is desirable that the valuations used with respect to the inventory of cotton and the elements of open position be placed on a liquidating basis, as of the date of the balance sheet, based on authoritative published market quotations. Due consideration must be given to the weight and the grade and staple classifications of the various bales of cotton ascertained to be in the inventory. Account must be taken of the location of the cotton, whether in the interior, at ports, in foreign warehouses, or in domestic mill territory. The basic valuations with respect to the cotton inventory should be obtained from the officially published quotations of the designated spot cotton markets, thus eliminating the effect of purely local conditions and opinions as to market values.

Quite a number of cotton merchants value the inventory, in so far as it may be possible to do so, by reference to delivery on a futures contract. This method to the writer's mind gives a true liquidating value in respect of cotton which falls within the classifications which are tenderable on a futures contract. The advantage arguable for such a method, when proper adjustments are made for the cost of carrying the cotton to the month of tender and the costs of delivery or tender, is the resulting definite valuation based on the published differences for grade and staple classifications in the officially designated spot cotton markets. Additionally, the normal functioning of the cotton market is such that the merchant can always dispose of his tenderable cotton against a futures contract. The merchant has in his own hands the control of this matter and need not wait

until his cotton is sold and delivered, lot by lot of a specified character, to a variety of buyers and with the usual delays and risks of trade. When the cotton merchant has the necessary open short futures, this method of valuation is the equivalent of closing his position as to those futures and the related tenderable cotton. If the merchant does not have such short futures in his position, they may be contracted for immediately.

The valuation of cotton in the inventory, which is not of tenderable classification, should be made to conform in valuation with tender prices, with adjustments for grade and staple differences and with sufficient discounts to provide for a conservative valuation for low grades and to cover the possibility of postponed liquidation.

In addition to the valuation of the cotton inventory at market values, by one or other of the methods, which definitely are standard trade practice, the cotton merchant must value, for financial statement purposes, the effect of his obligations on open contracts, whether to buy or sell actual cotton, or as existing in his position of open futures.

In the matter of computation of the market value of the inventory the cotton merchant will base his valuations on the nearest active futures month in relation to which cotton is being bought and sold at the date of his balance sheet. Thus, if the close of the merchant's fiscal year is July 31st, with the balance sheet being prepared as of that date, cotton valuations will be based "on" or "off" the October futures contract, as quoted at the close of July 31 on the New York Cotton Exchange.

The recognized financial effect of the merchant's market position, that is open futures contracts, unfilled fixed purchases and sales, and provisional purchases received or provisional sales shipped, is computed by effecting a theoretical close-out of all these items, by reference to the closing quotations at the balance sheet date in respect of the various futures months involved in the individual open contracts. Thus, a contract undertaken, based on a given futures month, for example December, is valued by calculating the differences, existing at the date of the financial statements, between the quoted price of December futures at that date and at the date of fixation of the contract.

For the accountant it does not appear to be necessary to quote any examples of such computations. However, when the various debit amounts and credit amounts are computed and are marshalled properly with regard to the merchant's debtors and creditors, and after adjustment for margin deposits or account balances pro or con, the results are included in the accounts and the financial statements under

the classification of "market differences on open contracts," and are included among the current assets and the current liabilities. A preferred treatment is to show the results as affecting brokers separately, and to include in the classification of "market differences" only those relating to open spot cotton transactions. This treatment is suggested by reason of varying credit risks which may obtain and the different conditions which exist as to margin demands.

When one considers the cotton merchant's method of doing business and his use of the futures market to minimize his risks from market fluctuations, it should be evident that to omit, as unfortunately one has seen done, from his financial statements, the effect of such computations as have been described, would fail to show a proper financial position.

Without in any sense admitting that what is permissive for federal income tax purposes is controlling for proper financial statement presentation, it should be observed that the Treasury Department has specifically recognized the noted trade practices of dealers in cotton, grain, and other fungible commodities dealt in on an organized exchange.

In the valuation of a cotton merchant's obligations on open transactions, the fluctuations of futures market prices have been recognized, but the question of "basis" variations has not been taken into account. In considering valuations of the inventory and of open contracts, effect has been given, for the purpose of putting the statements on a liquidating basis, to such items as are within the merchant's undisputed and immediate control. The liquidation of the tenderable portion of the inventory may be controlled by delivery on contracts, and open futures contracts, as well as fixed forward sales and purchases and provisional purchases received and provisional sales shipped, have been balanced by a theoretical closing out of the futures months involved. Even in the case of an unbalanced market position, the merchant, if he so desired, could mature promptly his market position, except in the circumstance where a breakdown of suspension of the recognized exchanges existed. "Basis" risks are not within the category of controlled items, but are part of business risks, such as credit risks, which the merchant will have to meet at all times.

However, if at the date of the financial statements, it is found that the "basis", on which the merchant has sold cotton, is materially lower than that at which, according to the most reliable evidence, he could acquire the cotton to fill the sale, provided he does not have the required cotton in his inventory, then appropriate comment should be made as to the

possibility of loss. More conservatively, the computation of the estimated loss should be covered by an adequate reserve. "Basis" has been recognized in the valuation of the inventory of cotton on hand, but it should be noted that, to the extent of the tenderable portion of the inventory, liquidation may be controlled through delivery on futures contracts.

If the merchant has made sales at an unsatisfactory basis, and he has the equivalent cotton in his inventory, the reduction of inventory values to conform with that situation must be made.

The Treasury Department's recognition of the right of cotton merchants, if they so desire, to incorporate in their accounts such open future contracts to which they are parties, as are "hedges" against actual "spot" or cash transactions, contains the prohibition that no purely speculative transactions in futures not offset by actual spot or cash transactions or concurrent forward purchases or sales may be so included or taken into account in any manner until such transactions are actually closed by liquidation.

As noted previously the merchant may appear to have a balanced market position on an over-all basis, but may be badly unbalanced with respect to specific future months. Consequently one should leave the discussion of the extent of speculation involved in such a situation, or in the case where serious lack of balance exists in the basis position as to Strict Middling 15/16 inch cotton or any other quality of cotton, to those who may wish to embark on the pursuit of higher mathematics.

A. COTTON MERCHANT

BALANCE SHEET AS AT JULY 31, 1952

ASSETS:

Current Assets:		
Demand deposits in bank and cash on hand		$
Documents in transit, covering ..... bales shipped, documents covering ..... bales and aggregating $..... pledged to banks		$
Accounts receivable:		
Brokers	$	
Trade	$	$
Current claims on railroads and others		$
Market differences on open contracts		$
Inventory of cotton, ... bales at market value; ..... bales pledged to banks		$
Total current assets		$
Trade Investments, at cost:		
Stocks of domestic corporations (estimated (quoted) market value, $.....)	$	
Memberships in cotton exchanges (estimated market values $.....)	$	$
Fixed Assets:		
Leasehold improvements, furniture and fixtures, and automotive equipment at cost	$	
Less, Reserves for depreciation and amortization	$	$
Other Assets:		
Accounts receivable, officers	$	
Accounts receivable, employees	$	
Other noncurrent receivables	$	$
Prepaid expenses and deferred charges		$
		$

LIABILITIES:

Current Liabilities:		
Notes and advances payable to banks; documents in transit $....., and ..... bales included in the inventory, pledged as collateral		$
Notes payable to banks, unsecured		$
Accounts payable:		
Brokers	$	
Trade	$	
Officers and employees	$	$
Taxes accrued, other than taxes on income		$
Tax and other withholdings from employees		$
Federal and state taxes on income		$
Accrued liabilities:		
Cotton charges and expenses	$	
Claims payable	$	
Salaries, wages and commissions	$	$
Market differences on open contracts		$
Total current liabilities		$
Contingent Liabilities:		
For liability as endorser on drafts outstanding	$	

CAPITAL:

Capital Stock:		
Authorized ..... shares of common stock, par value $..... per share, issued and outstanding ..... shares	$	
Earned Surplus, statement annexed	$	$
		$

A. COTTON MERCHANT

STATEMENT OF INCOME AND EARNED SURPLUS
FOR THE YEAR ENDED JULY 31, 1952

Gross Sales	B/c	$	
Add or deduct hedges		$	$
Less, Sales deductions:			
Freight, outbound		$	
Insurance		$	
Sales commissions		$	
Other sales charges		$	
Sales claims:			
Weight	$		
Grade and staple	$	$	$
			$
Cost of Sales:			
Inventory, August 1, 1951	B/c	$	
Purchases	B/c	$	
Purchase commissions		$	
Buyers' salaries and commissions		$	
Compress and handling charges		$	
Freight, inbound		$	
	B/c	$	
Less, Inventory, July 31, 1952	B/c	$	$
	B/c		
Gross Profit on Sales			$
Expenses:			
Salaries:			
Officers	$		
Employees	$	$	
Interest and exchange		$	
Telephone, telegraph and cable charges		$	
Traveling expenses		$	
Exchange and association dues and fees		$	
Rent		$	
Taxes, other than taxes on income		$	
General office expenses		$	
Depreciation and amortization		$	$
Net income from cotton			$
Other income:			
Dividends		$	
Interest		$	$
Net income, before taxes on income			$
Federal and state taxes on income			$
Net income			$
Balance in Earned Surplus Account as at August 1, 1951			$
			$
Deduct, Cash dividends of $..... per share paid on common stock			$
Balance in Earned Surplus Account as at July 31, 1952			$

The First of the Three "C's"

BY WARREN V. MCCONNELL
(Dallas Office)

Cattle, Cotton and Crude:

It is not alone the quips of the raconteurs, nor even the state of mind that is Texas, which have created the idea, held by many of those not having first hand acquaintance with the economy of the Southwest, that every Texan has an oil well in his back yard. During the final war year, 1945, Texas alone produced over 755 million barrels of crude oil out of a national aggregate of 1,713 million barrels. In the great Southwest, consisting of the states of Arkansas, Louisiana, Oklahoma, Texas and New Mexico, Texas does not stand alone in its importance as a producer of crude petroleum. During the same year Oklahoma ranked third, Louisiana fourth, New Mexico eighth and Arkansas ninth among the nation's producers, while these five states as a group, accounted for approximately 65% of the nation's and 49% of the world's recovery of crude oil.

Despite these impressive figures the Southwest does not have a unilateral economy. The petroleum industry is a Johnny-come-lately, as it were. Its importance came only into full being with the discovery and development of the vast East Texas field during the close of the second decade of the present century, and it is within the last year that the fiftieth anniversary of the Spindletop Dome discovery, the Southwest's very beginning as an oil producing area, was celebrated.

Long prior to that time cotton had been, and still remains, a prime factor in the development and prosperity of the Southwest. As in the instance of crude petroleum, Texas leads the nation in the growing of cotton. Its yield is the most valuable crop grown in any single political subdivision in the world, and its average value exceeds the total value of the production of all precious and other nonferrous metals mined in the entire United States. The four other southwestern states all rank among the first ten in the growth of cotton.

"Crude" and cotton are undoubted mainstays of the Southwest. But there is still another industry antedating both, which is so peculiarly an integral part of the Southwest as to seem to the older generation, at least, to be the incarnation of that vast region.

Many of the great land holdings and multitudinous herds of the 1870's have been broken up, and open ranges are but a memory,

but United States Department of Agriculture statistics cite 1945 as the year in which the greatest number of head of cattle roamed the ranges and pastures of the country. Estimates of present herds, while unofficial, are somewhat larger. Texas ranks first among the states in beef cattle production, while Oklahoma and New Mexico are among the most important cattle raising areas. Some proud old names remain, and their herds still are numbered in the tens of thousands; reminiscent of the days of the Texas Republic when its citizens depended upon stock raising as a major source of income—in fact about their only means of livelihood. Famous old brands such as the SMS of the Swensons, Matador's Flying V, Burnett's Four 6's, the JA of Adair and W. T. Waggoner Estate's Three D's are still represented by many thousands of head in their herds. The long horns were gradually replaced during the first quarter of the twentieth century by more desirable breeds, notably Herefords and Aberdeen-Angus. Somewhat later the Brahma was introduced from India and still more recently the King Ranch—the vastest operation of all—has developed the Santa Gertruda through cross breeding.

Oldest but still one of the Southwest's three principal sources of wealth, the cattle industry takes an understandable pride in its position and traditions. Who can blame it if it sometimes looks a bit patronizingly upon its more recent rivals.

Cash vs. Inventory:

To the practicing accountant in the Southwest are presented many problems and situations more or less indigenous to that area. In addition to clients who are solely or principally engaged in the business of breeding, raising and marketing livestock, many others have inherited ranches or have established herds as an avocation, with the result that a considerable portion of his practice relates to the cattle industry. Certain aspects of the accounting procedures which have been developed during recent years are equally applicable to the dairy industry and may, therefore, prove of nationwide interest, and thus appear worthy of comment.

In setting up the accounts of a livestock raiser the first consideration must be the question of inventories. The cattle industry discloses many examples of the alarmingly increasing number of enterprises which are basing their system of accounting on tax advantages, actual or presumed, rather than on sound accounting practices.

The Internal Revenue Code specifically authorizes the use of the cash receipts and disbursements basis for all farmers, including raisers of livestock. As inventories of supplies have no place in

accounts maintained on the basis of cash receipts and disbursements, many cattlemen believe that they can secure some tax advantages by regulating their purchases of winter feed stuff so as to have this, the largest item of expense, taken up either before or subsequent to the close of the taxable year; and for this reason have adopted the cash basis. The speciousness of this reasoning should be impressed upon the client. Purchases of livestock cannot under any circumstances be charged against current income when the cash basis is elected. Livestock purchased for work, breeding or dairy purposes should be capitalized and are properly subject to depreciation. The cost of livestock purchased for resale is a proper charge to cost of sales when those particular animals are sold. Here we sometimes encounter the anomaly of stating an inventory in a code of accounts set up on the basis of cash receipts and disbursements. This situation is quite common in the case of "feeders", the branch of the industry whose operations consist of buying calf crops, usually in the fall, fattening the young animals through the winter and then selling them as yearlings after May first. As the purchase and subsequent sale take place in different accounting periods, assuming that the feeder is on a calendar year, it stands to reason that the cost of the animals must be represented in his year-end balance sheet. Under such circumstances, and on the cash basis, no recognition can be afforded any increment in value through increased weight or market appreciation due to their reclassification as yearlings. Needless to say, no cost of sales can be charged on animals bred and raised by the seller.

For livestock raisers on an accrual basis the Bureau of Internal Revenue now recognizes four inventory methods, all of which are acceptable from the point of view of sound accounting principles, although one method appears to have such manifest advantages that its adoption should be much more widespread. The salient features of this method are presented in a brief resumé and examples in the following pages.

In addition to pricing inventories at cost, or the lower of cost or market, farmers generally, are permitted to value their inventory at market, less direct costs of disposal. This method, known as the "Farm Price Method" has little to commend itself to the cattlemen. On the other hand, the fourth option leaves little to be desired both as a sound accounting basis and as a tool of management.

Unit Livestock Price Method:

As its name, "Unit Livestock Price Method" indicates, it is peculiarly adapted, and applicable only, to the cattle raising industry, and is a fairly recent development.

For some time the cattle industry, particularly the operators of larger herds, and their accountants, had been working to evolve a costing method in respect of breeding of calves, on the theory that animal breeding was just as much a matter of the fabrication of an end product as was, for example, an automobile production line. Numerous approaches were attempted and by 1940 a recognized formula had been perfected and adopted by at least one of the Southwest's most important cattle companies. One obstacle, approval by the Treasury Department remained, and it was not until December, 1944, following litigation, that the regulations of the Bureau of Internal Revenue were amended to extend full recognition to the unit livestock price method.

The cardinal principle of this method is the assumption that all animals of each genus born during a given accounting period bear the same breeding cost, and increase equally in value from year to year, based upon their proportionate share of the annual raising cost.

The establishment of as nearly accurate quantitative inventories as possible, referred to in the industry as "tallies", is essential. Classification as to kind (cattle, horses, etc.), sex and age must be made, and further segregation as between animals held for breeding or dairy purposes as opposed those to be marketed.

With the normal accounting records, maintained on an accrual basis, the cattle raiser is then in a position to develop the average per head breeding and raising expense for the accounting period. The first step in this calculation is to allocate all expenses as between:

Breeding and raising expenses, and
Selling, general and administrative expenses.

An illustrative example of this calculation is shown by the first accompanying exhibit in which it will be observed that certain expenses are prorated, as for instance 90% of the wages of cowboys and helpers are considered as breeding and raising costs. The allocations employed in the accompanying exhibit have been accepted by the Treasury Department.

Before attempting to allocate the average per head *breeding and raising* expense to its components, two universally accepted trade practices should be understood. These are:

(a) Irrespective of the ending date of the accounting year, or the actual date of its birth, the age of every animal increases by one year, each first day of May.

(b) Female and uncastrated male animals, having passed their second May first are considered breeding animals. (It should be noted, however, that this article relates specifically to the cattle industry. Beef and dairy animals as well as their most necessary adjunct, horses, are all considered breeding stock at two years old. Some other animals have an earlier maturity.)

Having determined the average per head breeding and raising cost, the next step is to determine from the tally records the number of breeding animals in the cattle herd and the horse herd at the beginning of the accounting period. This might be for example:

Cattle sale herd:		
Cows	8,819	
Two year heifers	1,016	
Herd bulls	497	
Two year bulls	113	10,445
Cattle brood herd:		
Cows	319	
Two year heifers	62	
Herd bulls	8	
Two year bulls	1	390
Total breeding stock (cattle)		10,835
Horses brood herd:		
Mares		104
Two year fillies		18
Stallions		4
Total breeding stock (horses)		126

Having previously determined that the average per head breeding and raising cost was $12.9859 it is only necessary to multiply that cost by the number of head of breeding cattle, i.e., 10,835, to determine the amount allocable to breeding of calves, and by 126 to determine, in a like manner, the amount allocable to breeding of colts, which amounts are respectively $140,702.86 and $1,636.22. Further reference to tally records discloses that 6,149 calves were branded during the accounting year, and by dividing that number into $140,702.86, we arrive at a cost per head of calves branded, or in this instance $22.88 per calf. By a similar computation a cost of $16.87 per colt is developed.

At the beginning of the accounting year all animals on hand numbered 16,552, which quantity has been employed in computing the average per head breeding and raising expense developed in the accompanying exhibit. In calculating the breeding costs of calves and colts the respective numbers of head in the breeding herds aggregating 10,961 head have been considered. The remaining 5,591 head, consisting of younger animals, represent the growing herd, and it will be readily apparent that the cost applicable to these animals remains unchanged from the original computation; as a consequence $12.98 is to be added to their per head valuation on May first.

Having established the two essential cost factors it remains a fairly simple matter to compute the aggregate amount of the inventory, although there are several peculiarities which deserve mention.

Physical tallies of herds are far from a simple matter. The particular ranch on which the unit livestock price method was largely perfected consisted at that time of approximately 350,000 acres or nearly one-half of the area of the

state of Rhode Island. Much of this range is heavily covered with mesquite, salt cedar and sage brush, affording hiding places for the animals and making a thoroughly accurate count impossible. As a consequence calves, successfully hiding out one year, may be found unbranded and tallied as yearlings on the next annual round-up. This will result in an excess in the number of yearlings tallied over the computed quantity of that class of livestock. The resultant inventory adjustment is referred to as "writing back" and must be reflected as a credit to the current year's income.

On the other hand shortages in tallies are added to the known death loss of the particular class of animals and are accordingly a charge against income. The matter of the accounting treatment of death losses remained unsettled for many years. This was, however, clarified in *Adair Estate vs. Commissioner*, 43, BTA 384, in which it was held that death losses were deductible in the year sustained, and cannot be included, as had been contended by the Bureau, in breeding or growing costs.

Presuming that during the accounting year the ranch which we have been considering had sold 1,218 yearling heifers, death losses in that class had numbered 76, and that the respective costs of two year heifers, yearling heifers, and heifer calves, at the beginning of the accounting year, were $36.96, $30.54 and $18.77, the changes in the female groups of the cattle sales herd would be computed in the manner shown in the second accompanying exhibit.

Recognition of Capital Gains and Losses:

One other matter in connection with the accounts of the breeder of livestock is unique and of transcendent importance.

For many years cattlemen have maintained that their breeding and work animals were property used in trade or business and when sales from these herds were made for any reason, such sales should be so considered, for tax purposes at least, and be subject to the limitations of Section 117(j) of the Internal Revenue Code. At the same time dairymen advanced a similar premise in respect of dairy animals. These contentions were bitterly opposed by the Treasury Department, but after some years a partial victory was achieved by the breeders and they were enabled to class as gains under Section 117(j), the net long-term gains and losses on breeding animals, ***to the extent of the net quantitative reduction*** (by age and class) in their herds.

Having accomplished this much, there was wide diversity of opinion as to further steps. Many breeders, and it must be admitted that this school of thought was centered among the cattlemen of the South-

west, were apprehensive that further litigation looking towards the treatment of all sales of breeding animals, as capital gains, might induce the Congress to amend the Code to proscribe this treatment for the net reduction in herds. It remained for the dairymen of the Northwest to press the issue and in the *Albright* decision by the Eighth Circuit Court of Appeals the first substantial objective of the breeders was attained. This decision handed down in March 1949 was shortly thereafter followed by comparable findings by the Tax Court in *Fawn Lake Ranch Company vs. Commissioner*, 12 T.C. 1139. Thus encouraged, several cattle raisers who had consistently held to their position that their claims should be carried to the Supreme Court, if necessary, appealed adverse decisions of the District Court to the Fifth Circuit Court of Appeals, which found for the appellants in each instance.

With decisions in favor of the taxpayers in two circuits the Treasury Department withdrew, and it became a foregone conclusion that the Code would be amended, not to deny the treatment of some sales, but to specifically authorize the treatment of all sales of breeding stock as gains under the provisions of Section 117(j).

The authorization of this treatment was enacted into the Revenue Act of 1951, but with certain reservations, primarily, the extension of the holding period to one year.

EXHIBIT NO. 1

COMPUTATION OF AVERAGE PER HEAD BREEDING AND RAISING EXPENSE

	Total	*Breeding and Raising*	*Selling, General and Administrative*
Forage and grain	$ 51,936.92	$ 51,936.92	
Repairs and upkeep of properties	30,506.71	30,506.71	
Depreciation on ranch improvements and equipment	27,163.81	15,365.49	$11,798.32
Taxes on ranch property	23,577.30	23,577.30	
Fuel and lights	7,944.02	4,766.41	3,177.61
Commissary supplies	3,822.70	3,440.43	382.27
Grazing leases	23,846.76	23,846.76	
Salaries and wages:			
Officers	20,000.00	8,000.00	12,000.00
Superintendent	9,000.00	7,200.00	1,800.00
Cashier and bookkeeper	2,781.36		2,781.36
Cowboys and helpers	50,155.46	45,139.91	5,015.55
General expenses:			
Association dues	1,236.00	1,236.00	
Meals of employees while on the range	2,304.35	2,304.35	
Drugs and vaccine	832.27	832.27	
Employee medical expenses	1,137.80		1,137.80
Office supplies and sundry expenses	902.41		902.41
Telephone and telegraph	814.64		814.64
Advertising	346.16		346.16
Traveling expense	4,278.20		4,278.20
Auditing fees and expense	1,593.40		1,593.40
Recording fees, etc	252.75		252.75
Insurance and bond premiums	9,631.04		9,631.04
Interest	4,810.40		4,810.40
Miscellaneous expense	3,370.89		3,370.89
Legal fees	10,000.00		10,000.00
Sub total	292,245.35	218,152.55	74,092.80
Deduct, Lease and crop rentals ($2,574.87) and gain on sale of ranch equipment ($634.43)	3,209.30	3,209.30	
Total breeding and raising expenses applicable to all classes of breeding and growing stock	$289,036.05	$214,943.25(A)	$74,092.80
Inventory of breeding and growing stock at beginning of year		16,552 (B)	
Average per head breeding and raising expense (A divided by B)		$12.9859	

EXHIBIT NO. 2

EXHIBIT NO. 2

CHANGES IN INVENTORY OF LIVESTOCK DURING ACCOUNTING YEAR—CATTLE SALES HERD (IN PARTS)

	Debits			Credits			Inventory, December 31, 1952		
	Head	Per Head	Amount	Head	Per Head	Amount	Head	Per Head	Amount
Cows:									
1945 Promotions and transfers	831	$16.17	$ 13,437.27						
1946 Promotions and transfers	1,762	19.04	33,358.08				848	$19.04	$ 16,145.92
1947 Promotions and transfers	1,762	22.47	39,592.14				1,762	22.47	39,592.14
1947 Purchases	11	88.84	977.24				11	88.84	977.24
1948 Promotions	1,175	27.52	32,336.00				1,175	27.52	32,336.00
1949 Promotions	1,174	28.59	33,564.66				1,174	28.59	33,564.66
1950 Promotions	1,025	29.36	30,094.00				1,025	29.36	30,094.00
1951 Promotions	1,089	33.96	36,982.44				1,089	33.96	36,982.44
Inventory, December 31, 1951	8,819		220,341.83						
1952:									
Promoted from 2 year heifers	1,016	36.96	37,551.36				1,016	36.96	37,551.36
Transferred from brood herd (1948)	76	27.52	2,091.52				76	27.52	2,091.52
Death loss				221	$16.17	$ 3,573.57			
Sales (1,514 head)				610	16.17	9,863.70			
				904	19.04	17,212.16			
	9,911		259,984.71	1,735		30,649.43	8,176		229,335.28
Two year heifers:									
Inventory, December 31, 1951	1,016	36.96	37,551.36						
1952:									
Promoted to cows				1,016	36.96	37,551.36			
Promoted from yearling heifers	1,073	30.54	32,769.42						
1952 growing expense		12.98	13,927.54						
Transferred from brood herd	16	43.52	696.32						
Death loss				29	43.52	1,262.08			
	2,105		84,944.64	1,045		38,813.44	1,060	43.52	46,131.20
Yearling heifers:									
Inventory, December 31, 1951	1,073	30.54	32,769.42						
1952:									
Promoted to two year heifers				1,073	30.54	32,769.42			
Promoted from heifer calves	2,373	18.77	44,541.21						
1952 growing expense		12.98	30,801.54						
Transferred from brood herd	27	31.75	857.25						
Death loss				76	31.75	2,413.00			
Sales				1,218	31.75	38,671.50			
	3,473		108,969.42	2,367		73,853.92	1,106	31.75	35,115.50
Heifer calves:									
Inventory, December 31, 1951	2,373	18.77	44,541.21						
1952:									
Promoted to heifer yearlings				2,373	18.77	44,541.21			
Calves branded	3,032	22.88	69,372.16						
Sales				1,094	22.88	25,030.72			
Used by commissary				25	22.88	572.00			
	5,405		$113,913.37	3,492		$70,143.93	1,913	$22.88	$ 43,769.44

Tulsa, Oklahoma

By T. W. McKibben
(Tulsa Office)

On June 2, 1952, the Firm opened its Tulsa office in the First National Building of Tulsa, Oklahoma, the city's newest bank-office building. This is a nineteen-story, white brick and marble building, costing over $6,000,000 and was erected in the very heart of Tulsa's downtown business district by the joint efforts of the First National Bank and Trust Company of Tulsa and Sunray Oil Corporation, one of our clients. It is considered to be one of the most modern banking and office buildings in existence, completely air conditioned, with large picture windows surrounding the building on three sides. We are justly proud of our corner on the sixteenth floor with its beautiful view of the Osage hills, its light, airy rooms, its green carpets and walls, its red leather chairs, and its glass-topped desks.

But what of the city in which we hope to live a long and useful life? Where did it get its name? What is its ancestry? What is its personality?

Although Tulsa is still a youngster, as cities go, its origin, indirectly, pre-dates the Mayflower. In De Soto's account of his expedition in 1540, he tells of his visit to a large Creek Indian community, an old town, even then, called Tullahassee, located in what is now the state of Alabama. De Soto called this community "Talise" which is a contraction of two Creek words, "tulwa" meaning town, and "ahassee" meaning something old.

In 1836, after many skirmishes with the white settlers a group of these Creek Indians living near the community of "Talise" emigrated to an area on the east side of the Arkansas River just below its junction with the Cimarron River. Beneath the boughs of a giant oak tree (which is still standing in Tulsa at 1730 South Cheyenne Avenue) they dedicated their new home "Tulsey Town" in honor of their former residence.

Little of importance, or of historical record, occurred during the next half century. In fact, it is believed that the town was deserted and burned during the years of the Civil War when the Creeks fled into Kansas. However, the indomitable spirit of the city yet unborn, seemed to attract the returning Indians and the restless white men pushing westward in their search for better pastures on which to graze their cattle. Gradually Tulsa became a trading center where the Indians and white settlers exchanged deer and buffalo meat, wild turkey, pecans, pelts, and buckskins for farm implements,

cooking utensils, calico, and coffee, brought in by the railroad, and the cowboys from the south and west loaded their cattle for shipment "back East".

Tulsa, in the next fifty-year span, grew from a tiny, brawling, muddy "cowtown" of 1,400 people to a beautiful, enthusiastic metropolis of over 200,000 people. It changed from a town whose "Main Street" was only eighty feet wide (because it was too hard to wade in the mud any farther) to a clean, orderly city covering more than 20,500 acres. It moved, in those few short years, from "the end of the line" on the Frisco railroad to the geophysical center of Roger Babson's magic circle, containing the greatest wheat, corn, cotton and cattle-producing area on earth, the world's largest oil and gas fields, as well as the richest deposits of sulphur, lead, and zinc yet discovered.

However, oil is really the force which moved Tulsa through the pages of Oklahoma's early history. Although there are no oil wells within the city limits (they are prohibited by city ordinance), "black gold" was discovered just five miles from Tulsa on June 24, 1901. This discovery, known as the Red Fork Pool, did not result in an important oil field; but it was the beginning of prospecting for oil in the Indian Territory. Four years later, the Cleveland and Glenn Pools were discovered in the vicinity of Tulsa and Tulsa's destiny was settled. From that time on, Tulsa played a part in every major oil boom in Oklahoma, either furnishing men, material, and money, or merely providing a hospitable background at the old Robinson Hotel (clean rooms, good food, and a bathtub) for the many and varied "deals" that constitute a wild-catter's "stake." Through the ceaseless efforts of the Commercial Club, the forerunner of the present day Chamber of Commerce, and of certain private citizens with an unconquerable belief in the future of Tulsa, the first wagon bridge spanning the Arkansas River was built, railroad and pipeline connections were secured, and construction of a refinery was commenced.

The influx of drillers, tool pushers, and "roughnecks," who flood any "boom town," mixed with the lanky cowmen and the Creek Indians, gave Tulsa a rugged ancestry of which she can be proud. Tulsa is far enough north to escape the long periods of heat in the summer and far enough south to miss the extreme cold of the northern winter. The year-round temperature averages 61°. This pleasant climate, plus the contagious spirit of a city going someplace, appealed to these wandering oil field workers and roving cowpokes; and it was not long before they began to call Tulsa "home." To encourage this, far-sighted civic leaders induced the Frisco to run a 15-coach

commuter train from Tulsa to Okmulgee. This train, called "Coal-oil Johnny" by the oil men, departed from Tulsa early in the morning, leaving the oil field workers along the way and picking them up in the evening on the return trip to Tulsa. Soon the oil company executives and big ranchers caught the beauty and spark of this city and decided to make Tulsa their business home.

Today there are more than 700 oil companies, ranging from small independent producing and royalty companies to some of the largest producing, pipeline, and marketing companies in the world, with headquarters in Tulsa.

Naturally, with the coming of the oil companies, many allied industries, such as oil field equipment manufacturing and supply companies, drilling contractors, mud and chemical companies, refinery construction companies, geophysical and seismograph companies, lease brokers, and financiers, also followed the oil companies and made Tulsa their headquarters. According to the latest counts, some 9,700 people are employed in oil company offices, another 10,300 in their plants, refineries, laboratories, etc. Approximately 150,000 people in and around Tulsa are supported directly or indirectly by oil. The annual payroll of this group is estimated to be more than $65,000,000. It has been said that Tulsa has more scientific and technical personnel per capita than any other city in the United States.

Truly, Tulsa is the city that oil built and to settle its claim to the title "Oil Capital of the World," Tulsa proudly points to the International Petroleum Exposition consisting of more than 25 acres of permanent exhibits. Another "Oil Show" was held this year in May and had 5,000 exhibits representing some 1,200 oil companies and allied industries. These exhibits cost from a minimum of $5,000 each to a maximum of over $1,000,000 in the case of one oil field supply company. It was expected that 365,000 visitors would attend, including oil company representatives and government officials from 50 foreign countries.

While the men of Tulsa were busy trading cattle, corn, and calico, drilling holes in search of oil and gas, building skyscrapers, and otherwise giving their city a big, brawny body, the women were busy giving it a soul. It is significant that the first organization of record was a Sunday School organized in the fall of 1882 by the wife of a carpenter who was working on Tulsa's first train depot. The religious influence has been evident in Tulsa's growth from the time the "cowboys" and "roughnecks" fired their six-shooters over the heads of the departing church-goers, just to hear the girls scream, through the founding of a Presbyterian school, which later became the Tulsa public

school system, to the establishment of a fine university which bears the city's name. There are more than 4,000 students presently attending the University of Tulsa and its 30 permanent buildings are valued at more than $9,000,000. Tulsa also has many beautiful and famous churches. The Boston Avenue Methodist Church, designed and constructed by Tulsans, with its unique tower reaching toward the heavens almost 300 feet and the Holy Family Church, one of the first permanent buildings erected by a religious group, are just two outstanding examples.

Tulsa boasts of two beautiful museums to inspire and encourage a greater appreciation for the fine arts and to preserve the Indian tradition and folklore of the southwest. Philbrook Art Center was donated by Mr. and Mrs. Waite Phillips and is a beautiful, spacious, private residence formerly occupied by them. They also donated a downtown office building, the income from which is used to maintain the art center and its paintings valued at several millions of dollars. The other museum is the beautiful Gilcrease Foundation located high in the Osage hills overlooking the City, established by Thomas W. Gilcrease.

Tulsa is equally proud of its own Philharmonic Symphony Orchestra, the Tulsa Opera Club, and The Tulsa Little Theatre group, which owns and supports one of the finest Little Theatre buildings in the nation.

Tulsa's recreational facilities have changed, too, from the small ceremonial grounds laid out by the Creek Indians under that giant oak tree to a group of 19 beautiful public and private parks, formal gardens, etc. Included herein is Mohawk Park, consisting of almost 3,000 acres of landscaped grounds, with a large lake, golf course, picnic grounds, zoological gardens and numerous bridle paths.

But what of the future? Has Tulsa reached its peak of expansion? For the answer, one needs only to walk down the street to catch the enthusiasm of Tulsans, to feel their determination and their sureness of purpose, and to observe the large number of new office buildings and private dwellings under construction.

Tulsa's downtown business section, perched on top of a hill, like a lump of sugar in a saucer, now displays more buildings over ten stories high than any other city in America of equal population; and there are more already on the way or in the blueprint stage. The citizens of Tulsa only this year voted bonds of approximately $28,000,000 for a six-block civic center and a nine-story courthouse to cost approximately $4,500,000; Sinclair Oil Corporation is in the process of completing a new six-story office building; Stanolind Oil & Gas Company is completing a

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The purpose of this journal is to communicate to every member of the staff and office, plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

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EUROPE

LEONARD C. DAVID VICTOR L. NORRIS

Tulsa, Oklahoma

(Continued from preceding page)

$4,500,000 research laboratory; The National Bank of Tulsa is building a $1,500,000 annex for Carter Oil Company and other oil industry tenants. Skelly Oil Company and Sunray Oil Corporation have both announced plans for new buildings in the near future.

If the city continues to move through the next fifty years with the same speed it has shown in the last fifty years, the possibilities for the growth, expansion, and cultural development of Tulsa are truly unlimited.

Notes

Atlanta Office

Mr. Kenneth R. Shutts and Mr. Preston A. Sewell have recently become members of the American Institute of Accountants.

Chicago Office

Mr. Burke has been elected a director of the Chicago Chapter, National Association of Cost Accountants, for the year beginning July 1, 1953.

Mr. Clarence W. Schelb was a member of the Panel at the Cost Accounting Conference presented by the School of Business Administration, University of Michigan, sponsored by the National Association of Furniture Manufacturers, at Ann Arbor, Michigan, May 27–28, 1953. His subject was "The Budget—A Management Tool."

Detroit Office

Mr. Russell is currently active on the Finance Committee of The United Foundation. On May 26 his paper on "Coordination Between Independent Public Accountants and the Internal Auditing Department" was presented by Mr. Hobbs to the auditing class at Wayne University.

Mr. Hobbs recently served on the State Budget Committee of the United Health and Welfare Fund of Michigan.

Houston Office

Mr. Crouch was a member of a panel discussion of Office and Administrative Procedures of Practitioners at the Annual Meeting of the Texas Society of Certified Public Accountants at San Antonio, May 31–June 2, 1953.

Louisville Office

Mr. Halloran, as a director of the Louisville Credit Men's Association and Chairman of the Committee on Fraud Prevention, attended the 57th Annual Credit Congress in Montreal, Canada, May 17–21.

Mr. Franz E. Ross presented a paper entitled "Elementary Methods of Forecasting As Used in a Specific Utility Rate Case," and Mr. J. Wesley Huss participated in a panel discussion on the subject, "What Should We Teach in Freshman Mathematics?" at the spring meeting of the Mathematical Association of America held at the University of Louisville on May 9, 1953.

Mr. J. Martin Conder was a member of the Committee for the 4th Annual Institute on Accounting sponsored by the Kentucky Society of Certified Public Accountants at the University of Louisville, May 21–22. Mr. J. Wesley Huss presented a paper on "A Case Study in Tax Practice at the Institute."

Mr. J. Wesley Huss was a member of the panel in a forum on

Federal Income Taxes held by the Controllers Institute of America, Louisville Chapter; talked before the Torch Club on Tax Planning; and addressed the accounting seniors at the University of Louisville on "Opportunities in Public Accounting."

Los Angeles Office

Mr. Warner was appointed chairman of a special committee of the State C.P.A. Society on coordination with the League of California Municipalities and is serving on the State C.P.A. Society committee on cooperation with the State Bar Association.

Mr. Bowles was appointed chairman of the N.A.C.A., Los Angeles Chapter Nominating Committee and Auditing Committee and is serving on the State C.P.A. Society Nominating Committee. Mr. Bowles and Mr. J. W. Voris are serving on committees of the 1953 International N.A.C.A. Cost Conference to be held in Los Angeles in June.

Mr. C. A. Pearson recently addressed a meeting of the Tax Executives Institute in Los Angeles.

Staff members C. L. Davidson and F. Y. Garrison, Jr. have received licenses as certified public accountants in California.

New York Office

Messrs. Sinclair and Jennings were among the members of the firm attending the spring Council Meeting of the American Institute of Accountants held in Phoenix, Arizona, April 16.

Mr. R. G. Ankers has been reelected Secretary of the New York State Society of C.P.A.'s for the year beginning June 1, 1953.

Mr. Bardes acted as Chairman of the session on Pension and Profit-Sharing Plans at the 20th Annual Conference of the New York State Society of C.P.A.'s at Saranac Inn, June, 1953, and Mr. Ankers was a speaker at the session devoted to Professional Problems, discussing membership promotional plans.

Philadelphia Office

Mr. Mahon spoke on "Management Aspects of Taxation" at the Fifteenth Annual Institute on Accounting held at Ohio State University, May 21, 1953.

Mr. Hewitt was elected a Director of the N.A.C.A. at the Annual Meeting held in Los Angeles in June.

Tulsa Office

Mr. A. H. Degener is a member of the National Affairs Committee of the Tulsa Chamber of Commerce and also of the Action Corps of the Chamber. He is serving as a member of the Budget Committee of the Tulsa Community Chest.

Mr. J. W. McKibben is teaching a course in auditing at Tulsa University. He has been elected Treasurer of the Tulsa Chapter of the Oklahoma Society of C.P.A.'s.